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DEPARTMENT FOR EUR/AGS

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SUBJECT: Porsche Steps up VW Takeover Effort

REF: Frankfurt 1515

¶1. SUMMARY: Porsche, Germany's smallest automobile maker, has received permission from the EU to pursue a takeover of Volkswagen and has stepped up its efforts to acquire a majority stake in the company. Major hurdles remain, such as how to divide power in the supervisory board of a merged entity as well as state and federal government resistance to the move. Porsche will continue to pursue the takeover aggressively, as it offers a way for it to comply with EU CO2 emissions standards while also becoming a much larger player in the industry. END SUMMARY.

EU Gives Green Light

¶2. On July 23, the EU Commission approved Porsche's proposed attempt to take over Volkswagen (VW) saying that a merger would not hinder competition in the industry and related sectors. Family-owned Porsche, which currently owns 35.6% of VW stock, is looking to increase its holding to a controlling 51% stake. Regulators in the U.S., China and Russia have already given approval for a takeover as it relates to the interests of the two companies in those countries.

¶3. If the plan goes forward, the newly-created Porsche Holding Societas Europaea (SE) would become a new automobile giant in Europe. The company would also be at less risk of a hostile takeover, which many feared would happen to VW in 2005 when its share price tumbled. With profits currently dipping in the German automobile sector, companies such as VW and Daimler, which have no majority owner, remain at risk to such a move. A merger would also help Porsche comply with the EU directive to lower CO2 emissions to 120g per kilometer by 2012. Porsche's high-powered fleet presently produces 297g of CO2 per kilometer, the highest emission rate worldwide (see reftel). The average emission of a combined fleet would be significantly lower, giving Porsche a way around making drastic changes to its cars or paying large fines.

But Obstacles Remain

¶4. The takeover attempt gained momentum when the EU struck down Germany's so-named "VW law" in late 2007 arguing that it violated the free flow of capital. The law, created in 1960, gave the State of Lower Saxony a 20% blocking stake in VW, enabling it to prevent moves such as takeovers. A new version of the law, which attempts to comply with EU standards while also preserving Lower Saxony's blocking privilege, was passed by the German federal parliament (Bundestag) in May 2008. The EU Commission is presently reviewing the new law and many experts think it will also be struck down. Nevertheless, a merger can not be finalized until the commission rules.

¶5. The distribution of works council seats on the supervisory board of the new holding company has also turned into an obstacle in the negotiations. Like other large Germany-based companies, VW and

Porsche follow the co-determination model where a works council represents employees on the supervisory board. The current plan gives three seats to workers of each branch. Bernd Osterloh, chief of the VW Works Council, argues that with VW's 324,000 employees its workers deserve greater representation than Porsche's 12,000. Osterloh filed an interim injunction and other charges, which Ludwisgburg and Stuttgart Labor Courts rejected in November 2007 and April 2008 respectively. The VW Works Council appealed August 13 and a ruling is expected by the end of the year, but further appeals are possible which could further postpone a takeover. Osterloh has refused to attend a "peace summit" planned by the Metal Union IG Metal on co-determination unless the Porsche and VW Supervisory Board Chairmen also attend. The current ten-year agreement between Porsche and its works council cannot be terminated without agreement from the works council. Industry experts see in Osterloh's effort a fear of the changes Porsche would bring to the work culture at VW, including longer working hours, lower wages and a greater focus on profits, although Porsche has not explicitly said it would take such measures.

A Family Reunion of Sorts

¶6. Despite the differences in size, ownership structure and business model, VW and Porsche have intertwined histories that make a merger more likely. After founding Porsche in 1931, Ferdinand Porsche served as CEO of the newly founded VW in the 1930s and 1940s and designed the Beetle. He returned to Porsche after the war. Ferdinand Piech, one of his grandsons and one-time VW CEO, is currently Supervisory Board Chairman at Volkswagen. The two branches of the Porsche family, Porsche and Piech, jointly run Porsche. Long before the planned takeover, both companies had

shared research and development projects and suppliers. The Porsche Cayenne, VW Touareg and Audi Q7 are built on the same platform.

¶7. Porsche began increasing its 20% ownership of VW in 2005 to its current level. The move was initially seen as beneficial to Volkswagen in preventing a hostile takeover, but has also been criticized as a "creeping takeover" by a well-capitalized privately-owned company of a publicly-listed competitor exposed to the vicissitudes of the equities market. While Porsche produces far fewer cars than VW (96,794 to 5.2 million), its profit of 4.24 billion euros ($6.19 billion) in 2007 is slightly greater than VW's 4.12 billion ($6.01 billion).

¶8. COMMENT: Merging Porsche and VW would create the second largest automotive company worldwide that would also be able to comply with EU CO2 emissions standards. Possible factors that could derail the attempt include an economic downturn in Germany that hit automobile firms' profit margins and political maneuvering at the state or federal level against the move. While the way forward for a takeover is not yet completely clear, few of these barriers appear insurmountable in the long term. END COMMENT.

¶9. This cable was coordinated with Embassy Berlin and ConGen Hamburg.
POWELL